

INDIRECT COST ALLOCATION PLANS

**SECTION
900**

INDIRECT COST ALLOCATION PLANS

REGULATORY AUTHORITY

GENERAL GUIDANCE - FEDERAL PROGRAMS

905

The Office of Management and Budget (OMB) guidance for organizations that charge costs to federal programs is as follows:

<u>Entity type</u>	<u>OMB Circular</u>
Non-Profit Organizations	A-122
State, Local and Indian Tribal Governments	A-87
Educational Institutions	A-21

The cost principles in the three Circulars are, for the most part, similar. However, selected cost items are treated differently, depending on the type of entity. The following charts, which are reprinted from *OMB Circular A-133 Compliance Supplement* compare the treatment of certain costs among the circulars. Updated copies of the circulars can be downloaded from: <http://www.npr.gov/library/omb/numericl.html>.

COMPARISON AMONG OMB COST PRINCIPLES CIRCULARS

(Reprinted from *OMB Circular A-133 Compliance Supplement*, April 1999)

The following two exhibits provide comparisons between the OMB cost principles circulars. Exhibit 1 lists selected cost items for which treatment is not substantially identical among the three circulars. Exhibit 2 lists selected items that are unallowable in one or more of the cost principle circulars.

Several cost items are unique to one type of entity and not to other entities (e.g., commencement & convocation costs are only applicable to universities). The numbers in parentheses refer to the cost item in the applicable circulars.

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Exhibit 1 Selected Cost Items Not Treated the Same Among the Circulars (Reprinted from OMB Circular A-133 Compliance Supplement, April 1999)			
Selected Cost Items	A-87 - State, Local & Indian Tribal Governments	A-21 - Educational Institutions	A-122 - Non-Profit Organizations
Advertising & Public Relations	Allowable with restrictions - (2)	Allowable with restrictions - (1)	Allowable with restrictions - (1)
Bad Debts	Unallowable unless provided in program regulations - (7)	Unallowable	Unallowable - (3)
Bonding	Allowable - (8)	Not Addressed	Allowable - (5)
Civil Defense (local)	Not Addressed	Allowable with restrictions - (5)	Not Addressed
Compensation for Personal Services	Unique criteria for support - (11)	Unique criteria for support - (8)	Unique criteria for support - (7)
Defense & Prosecution of Criminal & Civil Proceedings	Allowable with restrictions - (14)	Allowable with restrictions - (11)	Allowable with restrictions - (10)
Goods or Services for Personal Use	Not Addressed	Unallowable - (19)	Unallowable - (18)
Housing & Personal Living Expenses	Not Addressed	Unallowable - (20)	Unallowable as overhead costs - (19)
Idle Facilities	Allowable with restrictions - (24)	Not Addressed	Allowable with restrictions - (20)
Interest, Fund Raising & Investment	Allowable with restrictions - (21, 26)	Allowable with restrictions - (22)	Allowable with restrictions - (23)
Lobbying	Unallowable (certain exceptions at State/local level) - (27)	Unallowable - (17, 24)	Unallowable - (21)
Memberships, Subscriptions, & Professional Activities	Allowable for civic, community & social organizations with Federal approval - (30)	Unallowable for civic, community & social organizations - (28)	Unallowable for civic, community & social organizations - (30)
Organizational Costs	Not Addressed	Not Addressed	Allowable with prior approval - (31)
Patents	Not Addressed	Allowable with restrictions - (29)	Allowable with restrictions - (35)
Professional Services Costs	Allowable with restrictions - (33)	Allowable with restrictions - (32)	Allowable with restrictions - (39)
Proposal Costs	Allowable with restrictions - (34)	Allowable with restrictions - (34)	Not Addressed
Publication & Printing	Allowable (35)	Not Addressed	Allowable with restrictions - (41)

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Exhibit 1 Selected Cost Items Not Treated the Same Among the Circulars (Reprinted from OMB Circular A-133 Compliance Supplement, April 1999)			
Selected Cost Items	A-87 - State, Local & Indian Tribal Governments	A-21 - Educational Institutions	A-122 - Non-Profit Organizations
Recruiting Costs	Allowable with restrictions - (2)	Allowable with restrictions - (37.b)	Allowable with restrictions - (44)
Relocation Costs	Not Addressed	Allowable with restrictions - (37.b)	Allowable with restrictions - (45)
Royalties	Not Addressed	Allowable with restrictions - (39)	Allowable with restrictions - (47)
Selling & Marketing	Not Addressed	Unallowable - (42)	Unallowable - (48)
Specialized Services Facilities	Not Addressed	Allowable with restrictions - (44)	Allowable with restrictions - (50)
Substantial Relocation - Interest Provision	Possible adjustment if relocated within useful life - (26)	Possible adjustment if relocated within 20 years - (22)	Possible adjustment if relocated within 20 years - (23)
Taxes	Allowable with restrictions - (39)	Allowable with restrictions - (46)	Allowable with restrictions - (51)
Termination Costs	Not Addressed	Allowable with restrictions - (49)	Allowable with restrictions - (52)
Training	Allowable for employee development - (40)	Allowable - (8.f)	Allowable with limitations - (53)
Travel	Allowable with restrictions - (41)	Allowable with restrictions - (48, 50)	Allowable with restrictions - (55)
Trustees (travel expense)	Not addressed	Unallowable - (50)	Allowable with restrictions - (56)

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Exhibit 2 Selected Unallowable Cost Items (Reprinted from OMB Circular A-133 Compliance Supplement, April 1999)			
Selected Cost Items	A-87 - State, Local & Indian Tribal Governments	A-21 – Educational Institutions	A-122 – Non-Profit Organizations
Advertising & Public Relations	Allowable with restrictions - (2)	Allowable with restrictions - (1)	Allowable with restrictions - (1)
Alcoholic Beverages	(4)	(2)	Unallowable - (2)
Alumni Activities	Not Applicable	(3)	Not Applicable
Audit Services	Allowable with restrictions - (5) and as addressed in OMB Circular A-133	Allowable with restrictions as addressed in OMB Circular A-133	Allowable with restrictions as addressed in OMB Circular A-133
Civil Defense (local)	Not Addressed	Allowable with restrictions - (5)	Not Addressed
Commencement & Convocations	Not Applicable	(6)	Not Applicable
Compensation – Institution Automobile	Not Addressed	(8.g)	Unallowable as overhead costs - (7g)
Contingencies	(12)	(9)	(8)
Defense & Prosecution of Criminal & Civil Proceedings	Allowable with restrictions - (14)	Allowable with restrictions - (11)	Allowable with restrictions - (10)
Donations & Contributions	(13)	(13)	(9, 12)
Entertainment	(18)	(15)	(14)
Fines and Penalties	Allowable with restrictions - (20)	Allowable with restrictions - (18)	Allowable with restrictions - (16)
General Government Expenses	(23)	Not Applicable	Not Applicable
Goods or Services for Personal Use	Not Addressed	Unallowable - (19)	Unallowable - (18)
Housing & Personal Living Expenses	Not Addressed	(20)	Unallowable as overhead costs - (19)
Idle Facilities	Allowable with restrictions - (24)	Not Addressed	Allowable with restrictions - (20)
Insurance & Indemnification	Allowable with restrictions - (25)	Allowable with restrictions - (21)	Allowable with restrictions - (22)
Interest, Fund Raising & Investment	Allowable with restrictions - (21, 26)	Allowable with restrictions - (22)	Allowable with restrictions - (23)
Lobbying	Unallowable except at State/local level - (27)	(17, 24)	(25)
Losses on Other Sponsored Programs	(42)	(25)	(26)
Memberships, Subscriptions & Professional Activities	Allowable with restrictions - (30)	Allowable with restrictions - (28)	Allowable with restrictions - (30)

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Exhibit 2 Selected Unallowable Cost Items (Reprinted from OMB Circular A-133 Compliance Supplement, April 1999)			
Selected Cost Items	A-87 - State, Local & Indian Tribal Governments	A-21 – Educational Institutions	A-122 – Non-Profit Organizations
Organizational Costs	Not Addressed	Not Addressed	Allowable with prior approval - (31)
Patents	Not Addressed	Allowable with restrictions - (29)	Allowable with restrictions - (35)
Pre-Agreement Costs	Allowable with restrictions - (32)	Allowable with restrictions - (31)	Allowable with restrictions - (38)
Publication & Printing	Allowable (35)	Not Addressed	Allowable with restrictions - (41)
Recruiting Costs	Allowable with restrictions - (2)	Allowable with restrictions - (37.b)	Allowable with restrictions - (44)
Relocation Costs	Not Addressed	Allowable with restrictions - (37.b)	Allowable with restrictions - (45)
Selling & Marketing	Not Addressed	(42)	Unallowable as overhead costs - (48)
Severance Pay	Allowable with restrictions - (11.g)	Allowable with restrictions - (43)	Allowable with restrictions - (49)
Student Activity Costs	Not Applicable	(45)	Not Applicable
Taxes	Allowable with restrictions - (39)	Allowable with restrictions- (46)	Allowable with restrictions (51)
Termination Costs	Not Addressed	Allowable with restrictions - (49)	Allowable with restrictions - (52)
Travel - First Class	(41)	(48)	(55)
Trustees (travel expense)	Not Applicable	(50)	Allowable with restrictions - (56)
Under recovery of Costs on Federal Agreements	(42)	(25)	(26)

FEDERAL GUIDANCE - SPECIFIC

910

The USDA's Food and Nutrition Service (FNS) publishes additional guidance for Nutrition programs (NPs). FNS Instruction 796-2, *Financial Management – Child and Adult Care Food Program*, provides guidelines for the allowability and allocation of costs.

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The U.S. Department of Health and Human Services has not published specific guidance for child development programs.

STATE PROGRAMS

915

1. **Guidance**

Contractors are expected to follow the federal guidelines of the OMB cost circular applicable to their organizational structure (see **SECTION 905** above). Programs administered through CDE should also adhere to the following guidance regarding allowable costs and cost allocation:

Program type	Guidance
Child Development programs (CDPs)	<i>Funding Terms and Conditions (FT&Cs)</i>
Nutrition programs (NPs)	Child and Adult Care Food Program (CACFP) <i>Budget Guidance</i>

As noted in **SECTION 438**, no indirect costs are reimbursable for Adult Basic Education (ABE) programs in accordance with ABE General and Program Assurances.

2. **FY '99-'00 Changes – Alternative Payment programs**

The definition of “other related child care costs” (ORCCC) and related references have been deleted. The requirements for the minimum level of direct payment to providers were changed to the former limit of *at least* 75 percent of net reimbursable program costs and no more than 15 percent in administration. For the Stages contracts, at least 80 percent of net reimbursable program costs must be direct payments to providers.

“Administrative costs” are defined as costs incurred for administrative activities where neither the family, the child nor the service providers directly benefit from the activity.

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COST ALLOCATION

ALLOWABLE COSTS

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Audit Risk: that costs unallowable under CDE awards have been included in the cost pool and allocated to a contract. Unallowable costs are more difficult to detect after they have been combined with other costs and spread to all of the programs.

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The auditor needs to be familiar with the costs that may be reimbursed under each program within the scope of the engagement. The regulatory guidance listed in **SECTIONS 905** through **915**, where applicable, should be referred to during audit planning and testing. In general, the cost circulars emphasize the importance of consistency, adequate documentation and reasonableness of costs charged by a contractor to a program.

Consistency – The contracting agency should apply its policies and procedures uniformly to both the government-financed programs and the other activities of the agency. Similar categories of cost should be accorded similar treatment, regardless of the program to which costs are charged, and all costs should be determined in accordance with GAAP.

The auditor should design tests to minimize the risk that the costs of one program were used to meet the cost sharing or matching requirements of another government-subsidized program. Cutoff tests can be applied to FYE reports to ensure that costs charged immediately before or after the FYE were not claimed in more than one period.

Adequate documentation - The contracting agency should have written support to substantiate costs charged to a program. This documentation should be consistent with the agency's policies and procedures.

The auditor should verify existence of a written cost allocation plan. If the agency uses an indirect cost allocation method, the rate cannot exceed 8% in any of the state child development programs. See **Section 930, Indirect Costs**, for negotiation and approval of indirect cost plans.

Reasonableness – When testing expenses charged to government-subsidized programs, the auditor should be cognizant of Federal and State requirements and the terms and conditions of the award. In addition, the auditor needs to use professional judgment in determining whether reimbursed costs are ordinary and necessary for the operation of the agency or performance of the contract.

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COST ALLOCATION

DIRECT COSTS

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Audit Risk: that a cost that has been allocated to an award as an indirect cost has also been assigned to the award as a direct cost. The auditor needs to be aware of the potential of “double-dipping.”

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If a cost can be specifically identified with other final cost objectives of the agency, then it is a direct cost of those objectives and cannot be assigned to other awards, directly or indirectly. However, a direct cost that is minor in amount can be treated as an indirect cost if that is more practical as long as the accounting treatment for such costs is applied consistently.

INDIRECT COSTS

930

Indirect costs are those that have been incurred for common or joint program objectives and cannot be readily identified with a particular final cost objective. Typical examples of indirect costs in CDE programs are:

1. depreciation on buildings and equipment
2. operating and maintenance costs
3. management salaries, benefits and overhead expenses
4. accounting

Audit Risk: that the agency’s indirect cost pool includes costs that should be charged directly to unallowable activities.

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In addition to the risks noted in **Sections 920 and 925**, the auditor should examine the agency’s treatment of unallowable costs. These costs should be treated as direct costs and be allocated their share of the agency’s indirect costs if these unallowable costs represent activities that:

1. include salaries
2. occupy space, and
3. benefit from the agency’s indirect costs.

For example, if an agency receives government funding for child development programs and it conducts fundraising activities, the costs associated with the fundraising are unallowable (under both federal and state awards). In addition to the direct costs of fundraising, all applicable indirect costs should be allocated to this unallowable cost group. The salary, benefits and other overhead costs of the individual responsible for the

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unallowable activity are examples of indirect costs that should be allocated to fundraising. The allocation for that employee should be based on the percentage of time devoted to fundraising.

COST ALLOCATION METHODS

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OMB Circulars A-122 and A-87 discuss four cost allocation methods. Regardless of the method implemented, the base used must be supported by current data, and it must accurately measure the benefits to each program or award.

The Direct Allocation Method is normally used by agencies that have only one major function and/or the agency's indirect costs consist exclusively of general and administrative (G&A) expenses. Costs are allocated as follows:

1. Costs are generally separated into three categories: G&A; Fundraising (or other unallowable activity); and Other Direct Functions.
2. Joint costs (i.e., depreciation, rent, and telephone expenses) are prorated individually as direct costs using a base appropriate to the cost.

Example allocation bases by program type:

Alternative Payment programs - Number of Children Served
Food programs – Staff Time per Fund
Resource & Referral programs – Staff Time per Fund
Center-Based programs – Adjusted Days of Enrollment

For agencies that have more than one major function, or its major functions benefit from indirect costs in varying degrees, it is more efficient to develop an indirect cost rate. As noted in **Section 920**, the resulting rate cannot exceed 8% in child development programs. The methods used to calculate indirect cost rates are:

1. Simplified allocation method
2. Multiple allocation base method
3. Special indirect cost rates

As noted in **Section 930**, costs that represent unallowable activities must be included as direct costs when calculating an indirect cost rate.

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COST ALLOCATION

The Simplified Allocation Method can be used when: 1) the federal award is not material; there is only one major function; or all major functions benefit equally from its indirect costs. Steps:

1. Total costs for the base period are separated as either direct or indirect.
2. Total *allowable* indirect costs (net of credits) are divided by an equitable distribution base.
 - a. Both the direct and indirect costs must exclude capital expenditures and unallowable costs.
 - b. The distribution base may be total direct costs (net of capital items), direct salaries and wages, or other base that results in an equitable distribution, and is common to the benefiting functions during the base period.

The Multiple Allocation Base Method should be used when an agency's indirect costs benefit its major functions in varying degrees. Steps:

1. Indirect costs are separated into cost groupings (pools of expenses of like character in relation to the benefits provided).
2. Each grouping is then allocated individually to the benefiting functions, using a base which best measures the benefits.
3. An indirect cost rate should be developed for each of the cost pools identified in Step 1, above.

If a cost grouping can be assigned directly to the function benefited, that is the allocation that should be made.

Special Indirect Cost Rates - Occasionally, an agency may perform an activity under a single award or group of awards that generates a significantly different level of indirect costs. In this case, a single indirect cost rate is inappropriate, and a rate for a special indirect cost pool should be developed during the course of the regular allocation process. The special rate should be used when the volume of work to which the rate would apply is material, and the rate should differ significantly from the rate that would have resulted from the other methods described above.

NEGOTIATION AND APPROVAL OF RATES

940

Federal – Preapproval of indirect cost rates must be made by the cognizant agency only if the funds are received directly from the federal government. The majority of federal funds for nutrition and child development programs are not received directly, but are passed through the CDE.

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State – Preapproval of indirect cost rates is only required by the CDE for certain agencies with center-based contracts. If such an agency has commingled childcare services (subsidized and nonsubsidized children in the same classroom at the same time), and the agency does not want to use Adjusted Days of Enrollment as its allocation base, preapproval by CDE is required.

All agencies must keep their cost allocation plan (CAP) on file at the agency's headquarters. Auditors should review and test the CAPs during the annual audit.

COMMON COST ALLOCATION ERRORS

945

Allocation of Payroll – The distribution of salaries and wages to awards for all employees (whether direct-charge or indirect allocation) must be supported by some type of personnel activity report. The documentation for *not-for-profit organizations* can include time sheets or distribution reports, but they must:

1. be prepared at least monthly and must coincide with one or more pay periods;
2. represent after-the-fact determinations of activity, rather than estimates;
3. coincide with one or more pay periods; and
4. be signed by the individual employee, or a supervisory official who has first-hand knowledge of the activities performed by the employee and can acknowledge whether the documentation provides a reasonable representation of the time worked in each grant during that particular period.

Local governments are required to maintain similar documentary support, except that the personnel activity reports must be signed by the individual employee. *Educational institutions* should review the provisions of OMB Circular A-21, section J (8) for additional payroll allocation provisions.

If an agency chooses to use distribution reports as the basis for cost allocation, the results should be verified monthly. Changes will necessitate a revision to the CAP. The agency must document each period (month or pay period) the verification was performed, and the results.

For new programs or staff positions, allocations may be made initially on the basis of estimates before the services are performed, provided that such allocations are promptly adjusted if activity records indicate significant differences.

Misallocation of square footage - If facility expenses are prorated, the time-floor method of allocation is recommended. Proration will be based on the floor area occupied by the program in proportion to the total floor area and the percent of time such floor area is used. This should be supported by the personnel activity reports.

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Lack of consistency – The same type of cost should be treated in the same manner in all programs.

FACILITIES & ADMINISTRATION COSTS

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The three OMB cost principles circulars differ in the treatment and/or definition of Facilities and Administration (F&A) costs:

Not-for-profit - Organizations that receive more than \$10 million in Federal funding of direct costs in a fiscal year are required to separate the indirect cost component into these two categories. The rate for each category must be stated as the percentage that the amount of the particular indirect cost category (facilities or administration) is of the distribution base identified with that category. This is described in detail in OMB Circular A-122.

Local Governments – OMB Circular A-87 does not require a breakout of F&A costs, regardless of the amount of Federal funding received.

Educational Institutions – For the purpose of OMB Circular A-21, F&A costs are synonymous with “indirect costs.”